



October 2009

Ukraine and Energy Community: The law of attraction of energy

Daria Ryabkova, Observer of the *Investgazeta*

Highlights

Ukraine can become a member of the Energy Community, whose goal is to establish a single regional energy market. Membership means real integration into the EU energy market

Once Ukraine becomes a member of the Energy Community, its principal energy players will undergo major changes, as the country will be required to reform its energy market

Joining the Community will resolve two important matters for Ukraine: stimulating the launch of overdue reforms of the energy market and bringing Ukraine closer to the EU

The EU is not offering Ukraine direct financial support for the implementation of its Energy Community Treaty commitments. It may, however, provide other types of assistance – for example, budget support for energy sector reform

"The trouble with Ukrainian politicians is that they always start towards their goals at the ninth step rather than the first one." Roman Shpek, now vice-president of Alfa Bank Ukraine, says this every time we meet. Not long ago, he spent eight years as Ukraine's representative to the EU. "Is it that they just don't understand that they've mixed up their steps? Or is it that they don't even know what path they're on?"

The guilty parties themselves, those running the country, make it difficult not to agree with him. They seem almost on purpose to turn around and offer the latest example of this principle in action, proving Mr. Shpek right.

Ukraine's politicians claim that they want this to become a flourishing nation—without having first achieved the flowering of each individual sector of the country's economy. They want the nation to be united—without having come up with a single national vision. The same holds true for European integration: Kyiv wants to join the EU, yet frequently fails to notice that when its readiness is broken down into separate points, this desire amounts to nothing.

Still, it looks like Kyiv has learned a few lessons by now and, instead of waiting for the final step, has decided to start from the first one in certain areas. Ukraine will shortly be signing an agreement to join the South East European Energy Community Treaty (SEE-EnCT), an organization that—provided Ukraine upholds all the rules and requirements—, will make the country a member of the European energy market. This, in turn, will be a major step towards Ukraine's integration into Europe.

Global goal in a local way

"A useful pocket project" is probably an apt name for the European Energy Community: an idealistic project of the European Union that is supposed to turn the Balkans into a single energy market that will be joined not only by the European Union, but all the countries on the Balkan peninsula.

The EU's main goal is to establish a single European energy market. Officials in Brussels have dreamt for decades about securing energy deliveries to the EU from third countries by diversifying sources and working to one day have a single EU external policy in energy. At the moment, every EU country estab-

lishes its own relationships with the external, non-EU world. Brussels will be able to achieve this when, instead of speaking with the voices of 27 individual countries, the EU will be able to speak with a single voice on the international arena. For this to happen, the Union needs to unify policy in the energy sector, which means unifying the energy markets of all these countries.

Still, Brussels understands that immediately uniting more than two dozen countries whose domestic energy markets are not very similar is a tall order. It will be much faster and easier to do the opposite: to establish a number of regional energy markets and then to combine those into one large one. This is why the EU is counting on regional integration projects.

In the spring of 2006, the EU even set up two regional initiatives: the Electricity Regional Initiative or ERI and the Gas Regional Initiative or GRI. These are intended to be the bridges, the transition stage between disparate national energy markets and a consolidated cross-European one.

This objective is to be served by the setting up of the European Energy Community as well, which was launched in 2002 under the Athens process.

The foundation of the EnCT is based on the example of an organization that emerged half a century earlier: the European Coal and Steel Community, which, at the time, was the real beginning of the history of a consolidated Europe. The hopes that are being placed today with the EnCT are also more-or-less the same.

A brief history of the EnCT

The EU began work to form the EnCT through the European Commission and individual Balkan countries in March 2002. At that time, they laid down the beginning of the Athens process, and agreed to set up a South East Europe Regional Energy Market, or SEE REM. In November 2002, the Commission, six countries in the region and Kosovo signed a Memorandum of Understanding in the power sector. In December 2003, a second MoU was signed regarding the natural gas sector.

In signing these two documents, the Balkan countries promised that they would reform their energy sectors as soon as possible and open their markets to third countries by 2015.

As these promises had no legally binding power, on November 25, 2005, an Agreement to Establish an Energy Community was put together. This time, it was binding, coming into force on July 1, 2006—after all the participating countries had ratified it.

The initiators of the EnCT hope to set up domestic energy markets in the Balkan countries that will be similar to one another. The idea is to then combine them into a single regional market and, finally, to combine all the European regional energy markets in such a way that they become a single large market.

Fortunately, the Balkans are surprisingly pliable material. The countries in this region are not deeply penetrated by natural gas networks. This means that, if Brussels can help them establish a single energy market today, tomorrow it will be able to influence the plans of Balkan countries regarding the construction of new gas and oil pipelines and underground gas reservoirs, and their relations with

third-country suppliers, whether that is the Caspian Basin, Russia or whoever. In this way, the EU will be able to kill several birds with one stone: to establish "its own" transit region, with underground gas cisterns, to diversify its suppliers, and to diversify the countries that its fuel transits through. Expanding cross-border trade in energy would increase diversification. One result of that, in turn, will be greater delivery security.

On the other hand, for countries that are participating in this project on the Balkan Peninsula, benefits from membership in the EnCT do not differ at all from those from membership in the EU itself. Guided by the easy hand of Brussels, the Balkans plan

to build a single energy market by first launching serious reforms on their domestic markets in order to bring them to a Common Market Design. The energy sector in each of the Balkan countries has to become competitive, and instead of the traditional vertically-integrated structure, they are supposed to demonstrate that their markets have a large number of distinct players on the market who are independent of each other. This will make it easier to make the power systems of each country in the region more energy-efficient. Still, the Balkan energy markets will all also have the same legislation and a similar regulatory base. This means that they will be able to trade power and gas across each other's borders without restriction.

In addition, this will make it possible to solve the problem of insufficient power at peak times and the cost of resources in the Balkans. Thus, by integrating the electrical networks in Southeastern Europe, operating costs in this sector will likely go down 11%.

The Balkans are expected to finish setting up a single regional power market by 2015. While the Balkans adapt to EU legislation at varying speeds, Brussels is looking to expand the circle of participants in its energy project, having added Ukraine and Norway to the list. These two are currently EnCT observers, along with Turkey, Moldova and Georgia.

Leaders and laggards in the formation of a single energy market

By 2015, the residential electricity market is supposed to be liberalized while industrial users were supposed to begin to live by the new rules already in 2008. True, these countries are not really managing to do this within the timeframes established.

In the Balkans, the European Union's most determined partner in terms of building a single energy market is actually Albania. This country has already properly adopted nearly all the necessary legislation, fulfilled all the requirements of the EU, expanded the functions and responsibilities of its regulators, and so on. Other countries that are getting top marks on the single energy market are Croatia and Kosovo. Today, Croatia and Kosovo are also almost ready to link up their power grids.

By contrast, Serbia and Montenegro have barely managed to adopt the necessary documents while Bosnia&Herzegovina is simply marking time altogether. Still, the worst results are in reforming their gas sectors. The main element retarding their progress is their political climate, much like Ukraine.

Why does Ukraine need the EnCT?

After the regional energy market is set up, its members—the Balkans, the EU and (if it wants) Ukraine—will develop a consolidated foreign trade and foreign policy position on the issue of resource trading. Moreover, the EnCT will give its members yet another, extremely significant guarantee. The agreement will guarantee that if one of the members finds its supply of electricity or gas suspended, all the other members of the Community will react as one to the threat. Indeed, if the Energy Community does provide such a commitment, it will be a first, as the EU itself can not today offer any such guarantees.

In other words, joining this organization will help Ukraine open the door to the world of new energy relations with its foreign partners. And this isn't all. Never mind that this will become a major push for overdue reforms in Ukraine's own energy sector, without which the country's economy will continue to lose its competitive edge on the world arena. Like all the other countries in the Energy Community, having joined, Kyiv will begin its path to integration in the European energy market, with all the potential benefits of membership that were listed earlier.

Ukraine is ready to start integration now. In December 2008, the Secretariat of the Energy Community held its first talks with Kyiv regarding Ukraine, which already had observer status in the EnCT, being given full membership in the organization. So far, Kyiv and Brussels have held several rounds. The last round ended 8 October and now the two sides are ready to sign a memorandum on joining the EnCT. Ukrainian officials expect this to be done in December of this year.

The laws of attraction

The state that Ukraine's energy sector is in today would not permit the country to integrate into the

EU energy sector. This means that, before joining, Kyiv has to bring its domestic power and gas sectors up to the same common denominator as the countries in the Balkan region.

The main features of this denominator will be defined in the agreement that Ukraine plans to sign with the European Energy Community. Its basis will be two basic documents: EU Directives 2003/54 and 2003/55 on reforming the electricity and natural gas sectors.

Of course, these Directives are not the crowning glory but merely the start of the legislative work this country needs to undertake. To be more precise,

Legislation Ukraine must pass to integrate into the EnCT's single energy market (and the EU)

1. EU Directives* 2003/54 and 2003/55, regarding the regulation of the power and gas sectors.

Planned implementation deadline:* 1.01.2012

2. Drafting and adopting legislation* that establishes specific changes on the gas and power markets and the overall concept called for in the designated Directives

Planned implementation deadline:* 1.01.2012

3. Acquis communautaire:

- ◊ in environmental protection (EEC Directive 85/337 on assessing the impact on the natural environment; EU Directive 1999/80, regarding a reduction in the sulfur content of fuels; EU Directive 2001/80 regarding large-scale waste-burning production facilities)
- ◊ in renewable energy (Directive on promoting renewable sources of energy and using biofuels)
- ◊ in electricity (Directive on liberalizing power markets and regulating cross-border trade in electricity)
- ◊ in oil and gas**

4. Parallel legislation.*

Ukraine must:

- ◊ join the ENTSO-E
- ◊ establish a deep Free Trade Area with the EU (in the context of an Agreement on Association between Ukraine and the EU)
- ◊ bring competition legislation in line with EU standards

Planned implementation deadline:* 1.01.2012

* Priority areas of legislative change.

** The EU Directives for this sector have not yet been drafted, although Kyiv and EnCT leadership have already agreed that in the future, Ukraine's reform will, in fact, tackle this area.

they only show the direction in which Ukraine has to travel. Drafting, planning and executing changes to Ukraine's legislation will have to be done independently and personally. Moreover, it will have to be done within a very concrete and ambitious timeframe. Ukraine has to adopt and enact new legislation and, most importantly, force the market to start making money based on the new scheme by 1 January 2012, according to prior agreements that are currently in effect. In turn, reforms to the domestic energy market will be a kind of "pre-operative therapy" that will make it possible to prepare Ukraine's power sector for the operation called "integration into the European energy market."

Incidentally, at the same time as it changes its own energy market internally, Ukraine is supposed to bind itself to a slew of external commitments. In addition to signing an agreement with the EnCT, Kyiv and Brussels will undertake a slew of satellite processes. In the power sector, we promise to join the Union for the European Network of Transmission System Operators for Electricity (ENTSO-E), which will handle the technical issue of exporting electricity from Ukraine to the EU. In the gas sector, we have undertaken a dialog with the EU regarding the modernization of Ukraine gas transit system. Finally, in the context of talks with the EU regarding a deep Free Trade Area, Kyiv is formulating a contractual basis for trading in electricity.

A way to resolve key problems

One of the key changes in the energy market will be the result of Directive 2003/54. As the main difference between the electricity market of the future and the market as it is today, Directive 2003/54 introduces an interesting term called "unbundling," which it applies to the process when monolithic industrial groups decide to voluntarily disaggregate themselves and to turn into more compact, mobile, independent entities.

To translate this into the language of Ukraine's power industry, the Directive calls for those areas of its operations where competition is physically im-

possible to be separated from those that can thrive on it. In short, the transmission and delivery of electricity should be separated from its generation and sale. Separate, functionally independent enterprises should take on these various functions.

In other words, the players on Ukraine's market today are looking at major changes in their lives. Today, a slew of oblenergos, for instance, function as both the seller and the distributor of power that is generated. After these reforms, the shareholders of all these oblenergos will be forced to think of how to reorganize their companies so that their activities are separated yet they don't find themselves in conflict over deciding on top management over each of the areas of operation.

At the same time, the Directive requires Ukraine to encourage the emergence of many new, smaller players on the market. And they, so the EnCT hopes, will have freer access to the network—at a separate price, of course.

Even greater "innovations" await the wholesale market for electricity. Today, this market contains a single buyer, the universal middleman between generators and oblenergos—the owners of the power transmission lines. This is Energorynok, a state company. It is Energorynok (literally, Power Market) that buys power formally from the generators and sells it on to the distributors. And at the same time, it guarantees that, when it comes to setting rates, the generators will be protected from the abuse of the oblenergos. Despite all these advantages, however, this system does not permit Ukraine to build alternative energy sources, as it prevents the buyer from deciding for itself, from which generator it wants to buy: the one that pollutes the air by generating with the use of coal, or the one that has modern mechanisms for environmentally-friendly generation of power.

If Kyiv decides to join the EnCT and, eventually, the European energy market, it will have to abandon this structure and allow power-generating companies (sellers) and distributors (users) to trade directly.

Making the illusory real

The changes awaiting Ukraine in the gas sector are no less radical. Today, this sector is an equation with many unknowns and the objective of reform according to Directive 2003/55 on the gas sector will not so much change the actual formula by which the market operates, but will clearly set things down on paper.

Currently, the natural gas market in Ukraine is simply not being regulated properly. For instance, there is legislation regarding the pipeline transport system and regarding the extraction of oil and gas. But trading in gas is not regulated anywhere. There is also no responsible regulator for this sector. And even if it were, it could not seriously affect the gas market, given how opaque it is, especially when it comes to the status of its major players.

In other words, Ukraine will not so much have to reform the gas sector as place it within a civilized legal framework and strengthen regulation. Only then will the question of ownership of networks be clearly regulated in Ukraine. Then its market will eventually have several—and possibly even several dozen—independent traders who will have open access to this network under law. Finally, a specially-created regulator will have to establish the rules of behavior for this market. One option would be to transfer these functions to NERC.

True, this is just a general approach, as we underscored earlier, whose actual directions will permeate Ukraine's power industry only after Kyiv signs its agreement with the EnCT. And just how, taking what steps Ukraine will achieve the necessary goal will depend entirely on the country itself.

The price of independence

A powerful independent regulator is probably one of the main requirements of the authors of the EnCT as far as the reform of the energy systems of its individual members is concerned. And this independence will be ensured by the very way that the regulator's work is organized. Its employees should not hold posts in any other organization whatsoever. Moreover, neither they nor the actual regulator should be financially tied to anyone, including, preferably, the country's leadership, in order to prevent the risk of political games around it.

Thus, in the context of reforming its energy sector, there could be a proposition that Ukraine not only establish a regulator for the gas sector (the NERC operates on the power market currently), but also guarantee that both regulators are completely fiscally independent. They could both work based not on Budget funding but on revenues that they collect for issuing licenses and from a general tax charged against the incomes of licensees from their energy-based operations.

Lobbying is unacceptable

At the moment, Ukraine's lawmakers are astonishingly passive, when it comes to the power sector. Their vision of the future look of the power market in Ukraine they have only passed along to NERC. Yet this vision is far from what Ukraine's power market should look like, based on the EU concept. For example, instead of dismantling a wholesale power market with a single electricity buyer in Ukraine, the NERC project proposes to simply switch the market to an exchange of two-way contracts.

Yet, there is little surprising in this. Reforms threaten the interests of nearly all players in the power sector in Ukraine. So, it is hardly likely that those whose wings will be clipped the most as a result of reforms, the oblennergos and Energorynok, will welcome reforms with open arms.

The same problems face the gas sector. Several draft Bills "On the basis for the natural gas market to function" have been hopelessly languishing for

years on the shelves of the Verkhovna Rada. The last one was submitted to the Rada by the Government in October 2009. Deputies lack the courage to pass it. The government must take the lead to push the laws be adopted.

On the one hand, transparent rules for operating on the markets could make the work of some of its players, such as the oblgases, much easier. On the other, no one really knows the entire system of "arrangements" on which the sale of gas works today in this country. We can safely assume that there are people who will lose commercially from the establishment of transparent rules of the game on this market. That means that those who try to vote to adopt this bill could find themselves facing opposition among those who are "not interested."

However, these are not the only issues over which there were differences between the European Union and the Ukrainian side. In addition to the two directives, as we noted, Ukraine will have to institute other EU Directives related to commitments in the future FTA agreement and the agreement on accession to the ENTSO-E.

Needless to say, these changes could face serious opposition from any number of interest groups in Ukraine. Their interests are understandable, of course. After all, it's hard to criticize someone who is being asked to voluntarily give up some of his income and influence.

Even in the EU itself, this problem has long been a monkey wrench in any general European energy security strategy. European companies are also not willing to weaken their positions. Still and all, we'd like to think that Ukraine has enough decisiveness to go ahead and take this step, as the price to be paid for remaining unreformed will be far higher than the dividends that certain interest groups gain today.

First reform, second money

In talking about any kind of reform, it's important to remember not only that it is useful and urgent. It's equally important to talk about what this reform

will cost the country and its people. In the case of Ukraine, where every step taken by politicians is measured by the number of votes they will get in the next election, this issue needs to be raised on an individual basis.

And there is plenty to talk about. In Ukraine, people are still not clear what it will cost to reform our power sector. And moreover, they have no clear idea where to find the money for this.

According to EnCT initiators, modernizing power generation needs to be done without state assistance, using private money. Of course, they understand that investors come in order to establish new capacities and modernize existing ones, and they have to be persuaded that, in the end, they will make their profits. This means that, at least with their Balkan counterparts, the European Commission has been urging the institution of a special mechanism for incentivizing interest—by signing Power Purchase Agreements (PPAs) with future buyers in advance. This kind of contract, the EU believes, can affirm for the potential investor that there will be demand for the power that he supplies.

Other sources of funding for reforms could be the privatization of any number of state enterprises. Europe's corruption fighters are convinced that this step could not only help fill Ukraine's coffers but will resolve any number of long-term problems: overstaffing, debts, and theft of electricity. Of course, the decision to privatize or not to privatize is entirely Kyiv's.

Still, our European colleagues understand quite well that, none of this can happen without a major injection of public money. For instance, it will be very hard to attract private investment to build power transmission lines and transmit power across borders. The amount of investment needed in the Balkans in this sphere, as an example, is estimated at EUR 340mn. This is why such projects either have to be financed from the public purse or from donor organizations. Of course, in Ukraine spare Budget funds for reforms will, as usual, not be available.

So far, Ukraine's European partners are not talking about financing within the official talks on joining the Community. Still, the question of providing assistance is actively being discussed in the context of other Ukraine-EU negotiations.

In addition, Ukraine has already received one contribution. The European Commission offered Budget support to carry out the "Support for instituting an Energy Strategy in Ukraine" worth EUR 23mn (altogether, the support adds up to EUR 82mn). True, the question remains open whether Ukrainians will use these funds and, if not, whom to hold responsible for that on the Ukrainian side. Now Kyiv is holding talks about having Ukraine's European partners find financial resources for the modernization of the country's gas transport system (GTS), too. It has also

already gotten agreement, with the intercession of the European Commission, that assistance money will be forthcoming for Naftogaz Ukrainy.

In other words, Ukraine is unlikely to be abandoned to its fate in the matter of funding reforms. It can expect assistance in the form of cash, advice and technical resources. After all, Brussels needs Ukraine's energy to be secure at least as much as its own. However, this realization should not be seen as "free meal" ticket for Ukraine. To get this assistance Kyiv will have to do some major, demanding and not always popular homework on the domestic market. No one can resolve Ukraine's problems without the country's participation. So, standing on one spot and waiting for outside help will get us absolutely nowhere when it comes to EU integration. Time to take that first step!

Daria Ryabkova—Observer of the Investgazeta, ICPS associate expert.

European Focus is an ICPS monthly that raises debate on key issues of European integration for Ukraine, EU policy towards Ukraine, and other important issues connected to Ukraine's European ambitions. Publication is financed by the Think Tank Fund of the Open Society Institute.